LEGISLATIVE SERVICES AGENCY
OFFICE OF FISCAL AND MANAGEMENT ANALYSIS
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FISCAL IMPACT STATEMENT

LS 6733 **DATE PREPARED:** Jan 14, 2001
BILL NUMBER: SB 393 **BILL AMENDED:**

SUBJECT: Inheritance Tax Valuation and Deduction.

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FUNDS AFFECTED: <u>X</u> **GENERAL**
DEDICATED
FEDERAL

IMPACT: State & Local

<u>**Summary of Legislation:**</u> The bill allows a deduction from the value of property interests transferred by a resident decedent equal to the amount of the decedent's interest in a qualified family-owned business deducted from the decedent's gross estate for federal Estate Tax purposes under Section 2057 of the Internal Revenue Code (the "QFOBI" deduction). The bill also provides that the finally determined federal Estate Tax value of a property interest is presumed to be the fair market value of the property interest for Indiana Inheritance Tax purposes. (The introduced version of this bill was prepared by the Probate Code Study Commission.)

<u>**Effective Date:**</u> July 1, 2001.

<u>**Explanation of State Expenditures:**</u> *County Replacement:* The bill could potentially result in a reduction in the amount of resident Inheritance Tax revenue retained by the counties. The revenue loss to counties statewide due to the QFOBI deduction for Indiana Inheritance Tax purposes is estimated to be $102,511. The revenue loss to counties from allowing the finally determined federal Estate Tax value to be the fair market value of a property interest is indeterminable and believed to be minimal. As a result of the revenue loss, the bill could potentially increase expenditures from the state General Fund relating to the Inheritance Tax replacement for counties. The impact on the state General Fund may not equal the revenue loss to the counties since most are retaining more revenue than is guaranteed under the replacement procedure. Since the Inheritance Tax does not have to be paid until a maximum of 18 months after the decedent's death (within 12 months of the date of death to receive the 5% early payment discount), the impact that the bill may have on county replacement would be somewhat delayed. See Explanation of Local Revenues, below, for further explanation of the replacement procedure.

Department of State Revenue: Information-sharing between the Department of State Revenue and the U. S. Internal Revenue Service could potentially minimize the administrative cost of tracking estates for the QFOBI deduction.

Explanation of State Revenues: The bill could potentially lead to a reduction in revenue from the Inheritance Tax and an increase in revenue from the Estate Tax. The bill is expected to reduce Inheritance Tax revenue by an estimated $1.21 M in FY 2003. The bill is also expected to increase Estate Tax revenue, but the amount of such increase is indeterminable. Further, the impact of state expenditures on county replacement increases the loss to the state to approximately $1.31 M in FY 2003. Again, this total would presumably be reduced by an increase in Estate Tax revenue.

Finally Determined Federal Estate Tax Value: The bill allows the finally determined federal Estate Tax value to be the fair market value of property interest for Indiana Inheritance Tax purposes. As a result, it is possible that some property interests could be valued at a lower amount than under current law. This would serve to decrease revenue from the Inheritance Tax. The amount of the revenue loss is indeterminable and is believed to be minimal.

Family-Owned Business Deduction: The bill allows a deduction from the value of transfers for purposes of the Inheritance Tax equal to the amount of the decedent's QFOBI deduction for purposes of the federal Estate Tax. The revenue loss from this provision is estimated to be approximately $1.21 M in FY 2003. This estimate is based on an Internal Revenue Service report indicating that 34 estates from Indiana which filed federal Estate Tax returns in 1999 utilized the QFOBI deduction. The QFOBI deductions by these 34 estates totaled approximately $22.31 M. Based on an effective Inheritance Tax rate equal to 5.43%, the revenue loss would be approximately $1.21 M. (The average QFOBI deduction taken by the 34 estates was $656,059. If the maximum deduction of $675,000 allowed under federal law had been taken, the revenue loss would increase to approximately $1.25 M.) The effective tax rate was estimated using an Office of Fiscal and Management Analysis (OFMA) database consisting of Inheritance Tax returns relating to decedents who died between July 1, 1997, and June 30, 2000. The database consists of 112,951 transferee records. It is assumed that the sample is representative of the universe of persons paying the Inheritance Tax. Only transferees receiving property interest transfers from estates which would be filing federal Estate Tax returns in 2001 (gross estate value of $675,000) were utilized. This sub-sample contained 14,319 transferee records. The tax rate is the ratio of the total Inheritance Tax liability of the transferees in the sub-sample to the total interest value for those transferees.

There are two important caveats to this estimate. First, the number of estates utilizing the deduction is expected to increase over the next several years. The deduction is new, becoming effective January 1, 1998. Policy analysts with the Statistics of Income Program of the U. S. Internal Revenue Service and with the Congressional Joint Tax Committee expect the count to increase over the next several years. Second, federal law requires that for purposes of the Estate Tax the amount of the QFOBI deduction is coordinated with the unified credit up to a total between the two of $1.3 M. Since the amount of the unified credit is increasing incrementally over the next six years (from $675,000 in 2001 to $1,000,000 in 2006), the amount of the QFOBI deduction that taxpayers could potentially access would be reduced to $300,000. While the first caveat may tend to increase the revenue loss from this provision, the second caveat may serve to offset any increase in the loss due to more taxpayers utilizing the deduction. If the number of taxpayers using the deduction remains about the same, but the value of the deduction reduces to $300,000 per estate, the revenue loss from this provision could ultimately drop to $553,860.

Explanation of Local Expenditures:

Explanation of Local Revenues: Counties retain 8% of the Inheritance Tax collected on transfers made by Indiana residents. The revenue loss to counties is estimated to be $102,510 statewide. It is important to note that a reduction in the amount of Inheritance Tax retained by counties due to the bill may be reimbursed by the state under the replacement provision established by P.L. 254-1997. The replacement provision was established when the Class A exemption was increased on July 1, 1997. The replacement provision guarantees that in each fiscal year each county receives an amount under the Inheritance Tax that is equal to the five-year annual average amount of Inheritance Tax revenue retained by that county from FY 1991 to FY 1997, excluding the highest and lowest year. Therefore, a reduction in tax retained by a county due to the bill would be reimbursed only to the extent that the changes made by the bill cause the amount of tax revenue retained by the county to fall below its guaranteed amount. Currently, most counties are retaining more Inheritance Tax revenue than is guaranteed under the replacement procedure. A copy of a spreadsheet showing the amount of Inheritance Tax replacement guaranteed to each county under P.L. 254-1997 is available from the Office of Fiscal and Management Analysis.

State Agencies Affected: Department of State Revenue.

Local Agencies Affected: Counties.

Information Sources: Bill Reynolds, Department of State Revenue, 232-2156.
Estate Tax Returns Filed in 1999 (Nation & Indiana): Selected Items by Taxable Status, Statistics of Income Program, U. S. Internal Revenue Service, January 2001.
Barry Johnson & Jacob Mikow, Statistics of Income Program, U. S. Internal Revenue Service, (202) 874-0316 & (202) 874-0313.
Mike Udell, Joint Tax Committee, U. S. Congress, (202) 226-7575.
OFMA Inheritance and Estate Tax Databases.
2001 U. S. Master Tax Guide, CCH.